No. 288

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*

v.

UNITED STATES

On Writ of Certiorari to the United States Court of Claims

REPLY BRIEF FOR PETITIONER

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I. RESPONDENT FAILS TO MEET THE ISSUE BEFORE THE COURT

From the original statement of the question in issue[1] throughout most of its brief, respondent fails to face squarely the issue involved in this proceeding, an issue which has not been decided previously on the merits by

[1] Brief for Respondent, p. 2.

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[1] Brief for Respondent, p. 2.

this Court.[2] The real problem is "how to compute income" under principles of accrual accounting where prepaid receipts are involved.

Respondent, on page 16 of its brief, attempts an identification of the problem in the following language:

> "Broadly stated, the question here is whether a taxpayer filing its federal income tax returns on the calendar year-accrual basis may postpone reporting *income* received in a given taxable year merely because the *income* represents consideration for services to be performed (or goods to be delivered) in a later year . . . ." (Italics supplied.)

In order to state the issue clearly, we must substitute for the italicized word "income", the correct words "prepaid receipts" or "prepaid dues", and we must add that deferral is made in order to match prepaid receipts with related revenue in the same taxable periods in order to reflect income clearly. The issue is not whether prepaid dues are includible in gross income, but when, i.e., in which taxable year—under accrual accounting, not cash accounting.

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[2] "Thus, the issue of the inclusion of prepaid income, *properly allocated* to future periods, in current taxable income was not passed upon by the Supreme Court" in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957). Behren, "Prepaid Income—Accounting Concepts and the Tax Law," 15 Tax L. Rev. 313, 360 (1960).

In *Brechner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, 526 (2d Cir. 1959), the United States Court of Appeals for the Second Circuit, in commenting on the *Michigan* case, observed:

"It is apparent from the decision of the majority that at least for purposes of the decision of the case it assumed that a realistic deferral would have been permissible, and found only that no realistic deferral was made."

In its brief respondent does not contend that petitioner's method of accounting for prepaid dues fails to conform with generally accepted principles of accrual accounting or that it fails to reflect its income clearly. The findings of fact of the Court of Claims and of the Commissioner of the Court of Claims who heard the testimony preclude such an argument.[3] To cover up this omission, respondent seeks to beg the question or to obscure it by the simple expedient of labeling prepaid dues as "income" when received, despite the fact that accrual and not cash accounting is in issue. Alternatively, respondent seeks to mislead the Court into believing that the issue involves the deductibility of a "contingent liability reserve",[4] or the deductibility of "estimated amounts of future expenses it [petitioner] expected to incur,"[5] neither of which, obviously, was the issue litigated in the Court below, and neither of which is the issue before this Court.

Respondent, in its brief,[6] discusses the problem of computing taxable income as though the Internal Revenue Code contained one list of items which are denominated "gross income" and another list of items which constitute "allowable deductions", and that "taxable income" during any annual period is computed by subtracting the latter from the former. While this approach has at least the merit of simplicity and could have some application to a cash basis taxpayer,

[3] Court of Claims' Finding 22, R. 66, and Finding 31, R. 70; Commissioner's Finding 22, R. 18, 19, Finding 33, R. 26.

[4] Brief for Respondent, p. 2.

[5] Brief for Respondent, p. 17.

[6] Brief for Respondent, pp. 17-18.

it ignores completely the provisions of the Code which refer to, authorize and approve the use of accrual accounting for federal income tax purposes.

The accrual method of accounting is expressly authorized by Section 446 of the 1954 Code, Section 41 of the 1939 Code and comparable provisions of every Revenue Act since 1916. And a basic principle of accrual accounting is that advances from members or customers, i.e., prepaid receipts, do not constitute revenue or income until such time as services are rendered or made available (or goods are delivered).

Not only is this a cardinal principle of accrual accounting which should be acceptable for tax purposes, since accrual accounting itself is acceptable, but accounting for prepaid receipts as taxable income in a taxable period different from the year of receipt is expressly authorized by a statutory provision entitled "General Rule for Taxable Year of Inclusion" of an item of gross income. Section 451 of the 1954 Code (as did Section 42(a) of the 1939 Code) provides:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Italics supplied.)

As a result of the application of this principle to this case, membership dues prepaid for twelve months in advance must not, in the case of an accrual basis taxpayer, be includible in taxable income for a taxable period except to the extent that the obligation to the members expires within such period. Respondent's brief fails to discuss the meaning and significance of

the above quoted statute which has a material, if not conclusive, bearing upon the disposition of this case.

In reading respondent's brief one would never suspect that the regulations of the Commissioner of Internal Revenue shed substantial light on the issue. The fact is that the Commissioner's own regulations both under the 1939 Code[7] and the 1954 Code unequivocally support petitioner's position.

Pertinent quotations from the Commissioner's Regulations interpreting the accounting provisions of the 1954 Code are as follows:

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. . . . A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. . . ."[8]
>
> "Generally, under an accrual method, income is to be included for the taxable year when all of the events have occurred which fix the right to receive such income and the amount thereof can be deter-

[7] Treas. Reg. 118, sec. 39.41-1 (1953) provide in part:

"The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the *fundamental rule* that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for . . ." (Italics supplied.)

[8] Treas. Reg., sec. 1.446-1(a)(2) (1957).

> mined with reasonable accuracy. . . . The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year."[9]

The confusion generated by respondent's brief is compounded by its numerous quotations from decisions of this Court which are alleged to constitute authority for the proposition that the annual accounting requirement prevents an accrual basis taxpayer from accounting for prepaid receipts as income later than the year of receipt. There are, of course, no such decisions of this Court. Respondent neglects to call attention to the fact that many of the decisions from which it quotes do not even involve accrual basis taxpayers, but refer to cash basis taxpayers.[10] Most of the other cases[11] cited by respondent involve the issue of the year of deductibility of an item of expense—contingent liabilities or disputed liabilities—and do not involve prepaid receipts in any respect.

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[9] Treas. Reg., sec. 1.446-1(c)(1)(ii) (1957).

[10] United States v. Lewis, 340 U.S. 590 (1951); Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931); Healy v. Commissioner, 345 U.S. 278 (1953); Guaranty Trust Co. v. Commissioner, 303 U.S. 493 (1938); Weiss v. Wiener, 279 U.S. 333 (1929); Heiner v. Mellon, 304 U.S. 271 (1938).

[11] Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); Brown v. Helvering, 291 U.S. 193 (1934); Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944); United States v. Anderson, 269 U.S. 422 (1926).

II. PETITIONER'S METHOD OF ACCOUNTING RESULTS IN REPORTING NET INCOME ON AN ANNUAL, NOT A TRANSACTIONAL BASIS

Respondent's constant repetition of the statement that taxable income must be reported on an annual, not a transactional basis would lead one to the conclusion either that petitioner does not report income until a transaction is concluded, or that petitioner does not file tax returns annually. Neither is the case. Petitioner never awaits the conclusion of a membership to compute the profit derived from the membership. And petitioner files its tax returns annually, reflecting therein, in accordance with customary rules of accrual accounting, all of the net income earned during the calendar year.

If petitioner receives advance annual dues of $15.00 from a member of one of its divisions on July 1st of a calendar year, petitioner recognizes and reports as gross income during the calendar year of receipt one-half of the amount received and does not wait until June 30th of the following year to determine whether or not upon completion of the membership there has been a net profit or loss. If, from July 1 to December 31, the expenses incurred by petitioner are $6.50 per member, petitioner reports $1.00 of taxable profit from the membership during the calendar year of receipt. If by June 30th of the following calendar year additional expenses of $8.50 per member are incurred, petitioner reports a loss from the deferred membership dues of $1.00 in the succeeding calendar year even though the over-all result of the transaction is $15.00 income, $15.00 expenses, and no profit whatsoever. This is clearly annual accounting and not transactional accounting, for to the extent that petitioner's obligation to serve the member has expired within the tax-

able year, the gross income, deductible expense and taxable income or loss for such year are reported in petitioner's income tax return. Petitioner does not delay or defer reporting dues as income until the membership is over.

Even a brief glance at the cases relied upon by respondent in support of the proposition that petitioner's method of accounting "fails to satisfy the annual accounting requirement" or constitutes "transactional accounting" makes it unmistakably clear that these cases either do not involve accrual accounting, or have no bearing upon the computation of income where prepaid receipts are involved.

Burnet v. *Sanford & Brooks Co.*,[12] was a case involving a cash basis taxpayer who could have changed the decision by the simple expedient of electing the long term construction contract method of reporting provided by the Treasury Regulations.

In *Guaranty Trust Co.* v. *Commissioner*,[13] relied upon by respondent, the taxpayer was a deceased individual who employed the cash basis of accounting. The question involved was the year of inclusion in income of the decedent's share of partnership profits where the partnership computed its income on a fiscal year basis. In the context of such facts, it is not hard to understand why the Court employed such language as "circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable and may thus affect the amount of tax." But it is difficult to understand why this language should be

[12] 282 U.S. 359 (1931).

[13] 303 U.S. 493 (1938).

quoted in a case which involves accrual accounting for prepaid receipts.

Security Flour Mills Co. v. *Commissioner*,[14] concerned the deductibility from concededly earned income in one year of payments made in subsequent years as to which no liability had accrued in the earlier years. This Court disallowed the deduction claimed by Security Mills because the taxpayer's accounting method was "a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system." (at 287).

United States v. *Lewis*,[15] and *Healy* v. *Commissioner*,[16] also dealt with cash basis taxpayers and obviously neither case concerned the issue of the propriety or the techniques of deferral of prepaid receipts permitted under Section 42 of the 1939 Code or Section 451 of the 1954 Code.

With respect to *Spencer, White & Prentis, Inc.* v. *Commissioner*,[17] respondent neglects to explain that this decision was rendered by the same court which in 1959 decided *Bressner Radio, Inc.* v. *Commissioner*,[18] which is the leading decision on the exact issue before the Court in this case. The *Spencer, White & Prentis* case involved the question of the deductibility of a contingent liability. The Second Circuit did not regard this decision as being sufficiently relevant to the problem of tax accounting for "prepaid receipts" to even cite it in the *Bressner* decision.

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[14] 321 U.S. 281 (1944).

[15] 340 U.S. 590 (1951).

[16] 345 U.S. 278 (1953).

[17] 144 F. 2d 45 (2d Cir. 1944), cert. denied 323 U.S. 780 (1944).

[18] 267 F. 2d 520 (2d Cir. 1959).

III. UNDER ACCRUAL ACCOUNTING, THE RECEIPT OF CASH OFTEN PRECEDES ITS INCLUSION IN INCOME AND THE ACTUAL PAYMENT OF AN ITEM OF EXPENSE OFTEN PRECEDES ITS DEDUCTIBILITY

Although this Court has pointed out repeatedly that for purposes of accrual accounting the time when cash is actually received is not controlling for tax purposes, respondent volunteers the following definition of accrual accounting on page 20 of its brief.

> "Under the 'accrual' method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not currently receivable, *but no later than the year of actual receipt*; conversely, deduction items are reported in the year in which they are incurred, i.e., when the liability to pay becomes fixed in fact and amount, even though payment is not then due, *but no later than the year of actual payment*." (Italics supplied)

Petitioner strenuously objects to that portion of the definition italicized above. The addition of the italicized phrases to the definition of accrual accounting would not only shock and amaze the accounting profession, but would result in the reversal of long established case law relating both to prepaid deductions and prepaid receipts. It would even reverse the position of the Commissioner of Internal Revenue with respect to many kinds of prepaid receipts and prepaid deductions of accrual basis taxpayers.

Apparently respondent is compelled to take this extreme position in order to make a consistent argument; but there can be no doubt about the fact that respondent's suggested definition goes too far. If, for example, an accrual basis taxpayer prepays rent on leased premises for a period extending beyond the close of its

taxable year, the Commissioner would not think of allowing a deduction in the year of payment for the entire amount of prepaid rent. The deduction must be prorated over the period for which the rent was paid. The case law has been settled on this point for many years. In *Bloedel's Jewelry, Inc.*[19] a calendar year-accrual basis taxpayer sought to obtain a tax deduction in 1920 for one year's rent prepaid to cover the period commencing September 1, 1920 and ending August 31, 1921. The Board of Tax Appeals upheld the determination of the Commissioner of Internal Revenue that only 4 12ths of the rent constituted a valid deduction for 1920. The remaining 8 12ths was not allowed as a deduction until 1921 in order that taxable income should not be distorted. See *Main & McKinney Building Co.* v. *Commissioner*,[20] *Baton Coal Co.*,[21] *Galatoire Bros.* v. *Lines*,[22] *J. Alland & Bro., Inc.* v. *United States*.[23] If an accrual basis taxpayer prepays fire or other insurance premiums for three years, for instance, not only would the Commissioner of Internal Revenue require the taxpayer to prorate the deduction over the period covered, *Higginbotham-Bailey-Logan Co.*,[24] but the Commissioner even requires a cash basis taxpayer to do the same. *Commissioner* v. *Boylston Market Assn.*,[25] *Martha R. Peters*,[26] *Bessie Cohen*,[27] G.C.M.

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[19] 2 B.T.A. 611 (1925).

[20] 113 F. 2d 81 (5th Cir. 1940).

[21] 19 B.T.A. 169 (1930), aff'd 51 F. 2d 469 (3d Cir. 1931).

[22] 23 F. 2d 676 (5th Cir. 1928).

[23] 28 F. 2d 792 (D.C. Mass. 1928).

[24] 8 B.T.A. 566 (1927).

[25] 131 F. 2d 966 (1st Cir. 1942).

[26] 4 T.C. 1236 (1945).

[27] 10 T.C.M. 29 (1951).

23587.[28] See G.C.M. 13148.[29] Similarly, interest prepaid by an accrual basis taxpayer must be deducted pro rata over the period to which the prepayment relates and not entirely in the year of payment. *Higginbotham-Bailey-Logan Co.*[30] And again, with respect to the same principle, expenses incurred by an accrual basis taxpayer in obtaining a loan which extends beyond the close of the taxable year must be deducted pro rata over the period of the loan. See *Longview Hilton Hotel Co.*[31] Clearly, it is not the law that the accrual of a deduction may never follow the year of payment—*where the payment is for an expense which relates to a period after the close of the taxable year.*

Neither is it the law that under accrual accounting prepaid receipts may *never* be accounted for as income later than the taxable year of receipt. In many areas of tax law the Commissioner of Internal Revenue has issued rulings[32] that prepaid receipts do not constitute

[28] 1943 C.B. 213.

[29] XIII-1 C.B. 67 (1936).

[30] 8 B.T.A. 566 (1927). Interest prepaid by a cash basis taxpayer on the other hand, is deductible when paid. *John D. Fackler*, 39 B.T.A. 395 (1939), acq. 1939-1 C.B. 11.

[31] 9 T.C. 180 (1947), acq. 1947-2 C.B. 3.

[32] Payments received by a travel agent in one year for cruise tickets, when the cruise was to take place the following years should not be accounted for as income in the year of receipt under accrual accounting. I.T. 2080, III-2 C.B. 48 (1924). 2 or 3 year prepaid subscription should be reflected as income pro rata as the magazine is delivered. I.T. 3369, 1940-1 C.B. 46. Advances received by a contractor in connection with long term contracts need not be reflected as income upon receipt. Treas. Reg., sec. 1.451-3 (1957).

income in the year of receipt. If these rulings are valid, the respondent's suggested definition of accrual accounting is invalid. Moreover, the principle which establishes the validity of these rulings should apply equally to all taxpayers similarly situated, including petitioner.

Where advance payments are received by an accrual basis taxpayer in consideration for goods to be delivered in a succeeding year, both the Commissioner of Internal Revenue and the courts have approved postponement of the inclusion of the advance as income until the goods were delivered. In *Veenstra & De Haan Coal Co.*,[33] an accrual basis taxpayer received $11,000 in 1943 for coal which could not be delivered until the following taxable year. Even the Tax Court recognized the error of taxing such advances as income in 1943—despite the fact that taxpayer had the cash on hand at the end of the year—since delivery of coal could not be made until the following year. The Commissioner of Internal Revenue acquiesced.[34] Similarly, in *Woodlawn Park Cemetery Co.*,[35] the Tax Court again held that prepaid receipts for cemetery crypts which were not completed until succeeding taxable years of the recipient did not constitute income to the recipient in the year of receipt—where accrual accounting was employed. Again the Commissioner acquiesced.[36]

The area of dispute now seems to be narrowed down to the year of taxation of prepaid receipts in connection with services to be rendered in the future—as con-

[33] 11 T.C. 964 (1948).

[34] 1949-1 C.B. 4.

[35] 16 T.C. 1067 (1951).

[36] 1951-2 C.B. 4.

trasted with goods to be delivered. There is no distinction between the two under generally accepted accounting principles;[37] and there should be no dispute for tax purposes where the rendition of services must take place in a succeeding year, where the cost of rendering the services cannot be incurred until the succeeding year, and where deferral is essential in order to match prepaid revenue with related expense and to reflect income clearly.

Whenever the problem of accounting for prepaid receipts, in connection with services to be rendered in the future, has been analyzed by the United States Courts of Appeal,[38] the decision has supported sound principles of accrual accounting. Without exception, the decisions of the United States Courts of Appeal which support the respondent's position in this case have been based upon the "claim of right" doctrine[39]—and respondent, in this case, concedes that the claim of right doctrine does not apply.[40]

[37] See authorities cited at 17-19 of petitioner's principal brief and testimony at R. 32, 33.

[38] Bressner Radio, Inc. v. Commissioner, 267 F. 2d 520 (2d Cir. 1959); Schlude v. Commissioner, 283 F. 2d 234 (8th Cir. 1960); Beacon Publishing Co. v. Commissioner, 218 F. 2d 697 (10th Cir. 1955); Bayshore Gardens, Inc. v. Commissioner, 267 F. 2d 55 (2d Cir. 1959).

[39] Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); Streight Radio and Television, Inc. v. Commissioner, 280 F. 2d 883 (7th Cir. 1960).

[40] Brief for respondent, p. 35 states:

"We agree with taxpayer (Br. 27-30) that the so-called claim of right doctrine is not directly applicable here . . ." The position of the Commissioner of Internal Revenue that prepaid receipts may never constitute taxable income later than the year of receipt is based entirely upon the claim of right doctrine. Rev. Rul. 60-85, 1960-1 C.B. 181. Since the respondent disavows that principle in this case for the first time there is no argument left which would support his position in this case.

IV. THE RESPONDENT'S METHOD OF ACCOUNTING WOULD IMPOSE AN INCOME TAX WHERE NO INCOME EXISTS AND IS PARTICULARLY INEQUITABLE IN THE CASE OF NEW AND GROWING BUSINESSES THAT RECEIVE MONEY IN ADVANCE OF PERFORMANCE

In *Bressner Radio, Inc.* v. *Commissioner*,[11] the Second Circuit pointed out that the method of accounting which the Commissioner sought to impose upon the taxpayer, which received prepaid receipts in connection with television service contracts, would not only distort income but would impose an income tax in years where the taxpayer actually operated at a loss.

Said the Court:

> "Furthermore, to compel this technique for tax purposes would further distort the result, in some cases grievously. Thus, in this case it was apparent to petitioner shortly after it commenced its service business that it would sustain a loss on each contract. Its accounting technique reflected a pro rata portion of that overall loss in each of the years of performance. Had the petitioner adopted what the Commissioner asserts would have been the only proper accounting procedure for tax purposes it would have shown a first-year taxable profit on most contracts, and a second-year loss which would have been heightened by the tax cost imposed in the first. Thus if petitioner had sold a service contract for $100 on April 1, 1948 it would have incurred expenses of $19 for installation and $19.62 for servicing for two months ($9.81 × 2). The balance of $61.38 would have been taxable income in the fiscal year of the sale and would have resulted in a tax of $23.32 (at 38%). This would have left petitioner with $38.06 to meet his service costs over the next ten months

[11] 267 F. 2d 520 (2d Cir. 1959).

> of $98.10. We have no doubt that such a technique of reporting would be a gross distortion of petitioner's income."[42]

In *Schlude* v. *Commissioner*,[43] counsel for taxpayer contended that had the Commissioner of Internal Revenue succeeded in requiring the taxpayer to report advance payments as income before the agreed upon dance lessons were given, the taxpayer would have been insolvent.

To illustrate the inaccuracy and inequity of respondent's method of accounting as applied to motor clubs, let us assume that a new club commences business on January 1, 1962 with a single member and adds one new member on the first day of each month for a 24 month period. For the sake of simplicity, let us assume that annual dues are $12 per member per year, payable in advance, and that the actual cost of serving one member per month is $1.00—an exact break even situation. During its first year of operations the aggregate advance dues collected by the club would be $144 (12 members × $12). Its expenses at $1.00 per member per month would total only $78 since its obligation to perform is only half completed. Respondent's position is that the club earned $66 of taxable income during its first calendar year and owes an income tax thereon. Under petitioner's method of accounting the club breaks even, of course. During the second year if a new member is added each month and all old members rejoin the aggregate advance dues collected total $288 (24 members × $12). Expenses at $1.00 per member per month equal $222, and again the

[42] 267 F. 2d at 524.

[43] 283 F. 2d 234 (8th Cir. 1960).

respondent contends that the club has a net profit of $66 and should pay an income tax thereon. In the third year, if the membership levels out at 24, the club collects advance dues of $288 and has expenses of $288, and it becomes clear the club has no profit.

Although it should be obvious from the foregoing example that the club has never earned any profit, the respondent's method of accounting would require the club to pay income taxes on a fictitious profit of $132. After taxes, the club would not have available adequate resources with which to meet its obligations since the club owes its members, in the aggregate, 132 months of future services which at the present rate will cost $1.00 per member per month. But the funds available to the club to provide such services are $132 less income taxes. So long as the membership of the club remains constant, the club will never recover the income taxes paid to the government in years when the club earned no income. While incongruous, it is true that under respondent's method of accounting, the faster the club grows, the sooner it approaches insolvency.

V. THERE IS NO VALIDITY TO RESPONDENT'S ARGUMENT WITH RESPECT TO EASE OF ADMINISTRATION

The respondent argues that advance receipts must be accounted for as taxable income no later than the year of receipt because this would facilitate administration of the tax laws from the point of view of the Commissioner of Internal Revenue. Respondent even contends there is no merit in computing income in a manner which matches expenses with related revenue for this would result in an

> " . . . enormous burden of evaluating and verifying complex statistical evidence submitted by mil-

> lions of taxpayers in an endless variety of business contexts to prove that they have reliably 'related' and 'matched' present income with estimated future expenses, or present expenses with estimated future income." [44]

Petitioner concedes that it would be more simple to administer the tax laws if all taxpayers were required to employ the cash method of accounting rather than the accrual method, but such is not the case. Administrative convenience to the Treasury Department should not outweigh legitimate interests of a taxpayer based upon express statutory authority, or permit the Commissioner to force the taxpayer to change from a long standing method of accounting which clearly reflects income to one which does not. Furthermore petitioner does not agree that the method of accounting which it seeks to sustain is complex. If advance receipts are not includible in income on a cash basis but on an accrual basis, the time of includibility is determined by the delivery of goods or the rendition of services. Neither of these events is unduly complex. In the "Handbook of Accounting Methods" (1943 edition, edited by J. K. Lasser), the section dealing with accounting methods for clubs provides, on page 517:

> " . . . Where dues are payable yearly in advance, and monthly income and expense statements are prepared, the proportionate amount of dues receivable for the month should be taken into income, and the unearned balance should be shown on the balance sheet as deferred income. . . . "

Insofar as a motor club is concerned, if advance dues are not required to be reported as taxable income on a cash basis, they are reportable as income during a tax-

[44] Brief for respondent, p. 33.

able year to the extent that petitioner's obligation to render or make available services to its members expires within the year. This is a simple yardstick. Similarly, if a manufacturer employing the accrual method of accounting receives payments in advance of delivery of goods, the advances are taken into account at the time of delivery. This is hardly complex.

Respondent also argues that the use of generally accepted accounting principles as applied to prepaid receipts gives too much flexibility to the taxpayer in computing income, but respondent confuses unwarranted flexibility with permissible choice. Even if there were an element of flexibility, there are numerous areas in the Internal Revenue Code in which a taxpayer may exercise a choice which has a bearing upon the computation of net income. As pointed out in a recent article, written by Robert Behren, entitled "Prepaid Income—Accounting Concepts and the Tax Law":

> "The choice of methods of valuing inventories, computing depreciation, and determining bad debt deductions; the adoption of the taxable year, the installment method, and the long-term contract method; even the basic determination of the method of accounting to be applied—all have an effect on the taxable income of an enterprise. Certainly, if the taxpayer is given the right to choose between the cash receipts and disbursements method and the accrual method in the first place, the Treasury should not complain of some lesser elections within the method chosen if in accord with 'generally accepted accounting principles.' The difference in taxable income of a business computed on the cash basis as compared to the accrual basis will generally be far greater than between taxable incomes computed on the accrual

basis where different accounting 'principles' are applied."[45]

Certainly, the Commissioner of Internal Revenue should accept the reasonable method employed by petitioner of reflecting advance dues as revenue over the period of a membership rather than entirely in the year of receipt, if consistently employed, and if income is clearly reflected.

VI. COMMERCIAL ACCOUNTING AND TAX ACCOUNTING ARE SYNONYMOUS TERMS IF INCOME IS CLEARLY REFLECTED EXCEPT IN THOSE INSTANCES WHERE THE INTERNAL REVENUE CODE PROVIDES TO THE CONTRARY

Respondent argues[46] that the Commissioner of Internal Revenue is not bound by commercial accounting principles; but this argument has no application to the disposition of this case since the use of standard accounting principles does reflect petitioner's income clearly.

The decisions of this Court cited by respondent[47] in support of its argument that commercial and tax accounting are different fail to supply any reasons for a departure from sound accounting principles where the taxation of prepaid receipts is in issue. In *Brown* v. *Helvering*, the taxpayer sought to change its method

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[45] Behren, "Prepaid Income—Accounting Concepts and the Tax Law", 17 Tax L. Rev. 343, 365 (1960).

[46] Brief for Respondent, pp. 36-41.

[47] Brown v. Helvering, 291 U.S. 193 (1934); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Lucas v. American Code Co., 280 U.S. 445 (1930); Bazley v. Commissioner, 331 U.S. 737 (1947), reh. denied 332 U.S. 752 (1947); Commissioner v. Hansen, 360 U.S. 446 (1959).

of accounting without the required approval of the Commissioner of Internal Revenue, an important fact not present in this case. In *Lucas* v. *American Code Co.*, the taxpayer sought to deduct a loss in connection with a breach of contract where the contract had "18 more years to run", where "liability for the breach was denied and strenuously contested . . .", and where "the amount of the damages, if any, was wholly unpredictable."[48] In *Bazley* v. *Commissioner of Internal Revenue* this Court determined that the corporate reorganization provisions were not intended to exempt from taxation the exchange of common stock for negotiable bonds which as a practical matter constituted *realized* gain. In *Commissioner* v. *Hansen* an accrual basis taxpayer was not permitted to escape accrual and taxation of that portion of its income derived from sales which the taxpayer permitted to be retained by a finance company as collateral security.

None of these cases involve correct accrual accounting for prepaid receipts. The only reference in such cases to a divergence, if any, between commercial accounting and tax accounting, was that corporate bookkeeping with respect to the nature of a transaction was not necessarily binding on the court. A holding to this effect is obviously not the same as a determination that cardinal principles of accrual accounting should be ignored in computing taxable income where advance payments are involved.

Respondent's argument also relegated to limbo the long standing regulations promulgated by the Commissioner of Internal Revenue which clearly approve the use of "standard methods of accounting" for federal

[48] 280 U.S. at 451.

income tax purposes—if regularly employed and if income is clearly reflected. The principle of accrual accounting which requires prepaid receipts to be reflected as revenue when services are provided or goods are delivered is one of the cornerstones of accrual accounting according to petitioner's accounting experts. Its use is required not for a conservative but an accurate determination of net income.

If we ignore the Commissioner's regulations approving the use of standard accounting principles in computing taxable income—provided income is clearly reflected—there is no suitable substitute for determining when or whether annual income is clearly reflected.

VII. NEITHER THE ENACTMENT AND REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954 NOR PETITIONER'S EFFORTS TO CURE BY LEGISLATION THE INEQUITABLE TAX TREATMENT OF PREPAID DUES WHICH RESPONDENT SEEKS TO FORCE UPON PETITIONER HAS ANY BEARING UPON THE DISPOSITION OF THIS LITIGATION.

In order to persuade Congress to repeal retroactively the provisions of Section 452 and 462 of the Internal Revenue Code of 1954, the Secretary of the Treasury gave his solemn word to the Congress that no inferences would be drawn from such repeal with respect to the status of prior law.

Despite this assurance 11 pages of respondent's brief[49] are devoted to the argument that the repeal of these sections does show "a Congressional understanding that no such method was permissible under existing law, . . ."[50]

[49] Brief for respondent, pp. 42-53.

[50] Brief for respondent, p. 45.

The exact language of the promise of the Secretary of the Treasury was contained in a letter to the Honorable Jere Cooper, then Chairman of the Committee on Ways and Means. It was dated March 22, 1955, and reads as follows:

> "My dear Mr. Chairman: This letter will confirm the statements made to you today by Treasury representatives.
>
> "I assure your committee that if H.R. 4725 as reported out by your committee is enacted, as I earnestly hope it will be, the Treasury Department will apply revenue ruling 54-608 (relating to the accrual of vacation pay) only to taxable years ending after December 31, 1955.
>
> "Furthermore, the Treasury Department will not consider the repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions and other items of prepaid income, *either under prior law or under other provisions of the 1954 code.* In other words, the repeal of section 452 will not be considered by the Department as either the acceptance or the rejection by Congress of the decision in *Beacon Publishing Co.* v. *Commissioner* (218 F. (2d) 697, C. A. 10, 1955) or any other judicial decisions.
>
> "It is my understanding *that the foregoing is consistent with the desire of your committee, with which I agree,* that the repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted."[51] [Italics supplied.]

[51] H.R. Rep. No. 293, 84th Cong., 1st Sess. 5 (1955).

The legislative history of the repeal of Sections 452 and 462 is equally clear on the point that Congress did not intend to disturb prior law.[52]

The *Beacon Publishing Company* case on which petitioner relies correctly interpreted existing law prior to the enactment of Section 452; the *Bressner Radio* and *Schlude* cases upon which petitioner relies correctly interpreetd existing law after the repeal of these sections. No inferences were drawn by these courts.

Respondent in this and other portions of its brief also seeks to give the impression that a decision in favor of petitioner might result in a substantial loss in tax revenue comparable to the loss anticipated by the Treasury Department if Sections 452 and 462 had not been repealed. Respondent fails to explain, however, that the loss in revenue which was anticipated as a result of the enactment of these sections stemmed from "the transition period."[53] In other words, in

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[52] "Your committee in repealing sections 452 and 462 does not intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes, including the treatment of prepaid newspaper subscriptions." H. Rep. No. 293, 84th Congr., 1st Sess. 4 (1955).

"Uncertainty will also exist in other areas with the repeal of these two provisions. In *Pacific Grape Products* (C.C.A. 9th, February 10, 1955) [219 F. 2d 862], for example, the circuit court held that certain freight and shipping expenses incurred after the end of the year could be accrued for tax purposes as of the end of the year. An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed." (S. Rep. No. 372, 84th Congr., 1st Sess. 5, 6 (1955).

[53] See H. Rep. No. 293, 84th Cong., 1st Sess. 3 (1955); S. Rep. No. 372, 84th Cong., 1st Sess. 4 (1955).

the year of transition a taxpayer received a deduction not only for the actual expenses incurred in such year but also for the newly created reserves for various expenses which would not be incurred until subsequent years. The often referred to "double" deduction in one year—the year of transition—was the primary cause of the anticipated revenue loss.

The double deduction was possible because these sections authorized a change in accounting methods without the customary consent of the Commissioner of Internal Revenue. Since petitioner is not seeking to change its long standing method of accounting, there is no transitional problem.

Petitioner's efforts to obtain legislation putting to an end any doubt about the right of a nonprofit motor club to report prepaid dues as income over the membership period commenced prior to the decision of this Court in *Automobile Club of Michigan* and have continued following such decision. As long as any motor club which employs the accrual method of accounting is denied the right to report prepaid dues over the membership period rather than in the year of receipt, petitioner, as representative of all motor clubs affiliated with the AAA, has the responsibility of seeking redress if possible. Its efforts, however, have no bearing upon the interpretation of Sections 446 and 451 of the Internal Revenue Code of 1954 nor of Sections 41 and 42(a) of the Internal Revenue Code of 1939—nor upon whether the income of any particular club is clearly reflected. Moreover, petitioner's efforts were not directed toward changing existing law, since there was no United States Supreme Court decision declaratory of existing law, but instead were directed toward eliminating the confusion which existed because of diverse

lower court decisions on the subject of accounting for prepaid receipts.

Respondent, prior to the decision of this Court in *United States* v. *Cannelton Sewer Pipe Company*,[54] sought to have Congress change the definition of "mining" for the purpose of computing percentage depletion to the definition actually approved by this Court in the *Cannelton* case.[55] Surely, if respondent has the prerogative of requesting legislation to end all doubt at the same time it is attempting to persuade the courts to adopt an interpretation of existing law which coincides with the legislation it seeks, the same privilege should not be denied a taxpayer.

CONCLUSION

For the first time in any income tax case involving proper accrual accounting for prepaid receipts, respondent admits that the "claim of right" doctrine is not directly applicable. Since such victories as Respondent has won on this issue, other than *Automobile Club of Michigan*, have been grounded on this theory, Respondent's abandonment of this argument in this case is not only surprising but revealing.

Respondent's substitute for the discarded claim of right argument is the simple equation that even in the

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[54] 364 U.S. 76 (1960).

[55] See letter of Secretary of the Treasury to Speaker of the House of Representatives dated January 26, 1959, found in the Congressional Record—Senate, June 18, 1960, at page 12,286. See also Congressional Record—Senate, June 18, 1960, at pages 12,283-12,310; June 20, 1960, pages 12,418-12,420; June 27, 1960, (the date on which the *Cannelton* decision was rendered), pages 13,461-13,465. See also Hearings Before the Committee on Ways and Means, House of Representatives, 86th Congress, 1st Session, March 5, 6, 9, 10 and 11, 1959.

case of an accrual basis taxpayer: prepaid receipts = taxable income. Respondent seeks to buttress this equation with a novel addition to the long standing definition of accrual accounting as approved by this Court. The addition is that money may never be accounted for as taxable income in a year subsequent to the year of receipt and items of expense may never be allowed as a deduction in a year subsequent to the year of payment. Insofar as prepaid receipts are concerned, the net effect of this new addition would be to authorize the Commissioner of Internal Revenue to either collect his income tax on the cash method of accounting or the accrual method of accounting, whichever results in earlier taxation, and irrespective of whether or not income is clearly reflected. Insofar as prepaid expenses are concerned, the respondent has not in the past and is not expected in the future to permit the deduction in one year of more than one year's expenses, his argument in this case to the contrary notwithstanding. The obviously unfair effort of the Commissioner to work both sides of the same street to his earliest and exclusive advantage should result in the early failure of this new approach.

Petitioner respectfully requests that the issue in this case should be resolved in the light of the applicable statutes which approve the use of accrual accounting for income tax purposes provided income is clearly reflected, and in the light of the Commissioner's own regulations that the use of standard accounting principles will be an acceptable yardstick to measure whether income is clearly reflected. In this case deferral of a pro-rata part of prepaid dues is essential in order to match in the same taxable

periods the cost of serving petitioner's members with related revenue.

Petitioner in this case has established as a fact that its method of accounting does reflect its income clearly. It has also proved the respondent's method does not. It has proved that no reputable accountant will certify to the accuracy of its profit and loss statements or its balance sheets if it is forced to accept respondent's method of accounting. Upon the facts established in this case, petitioner respectfully requests that the judgment of the Court of Claims should be reversed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES

No. 288.—October Term, 1960.

American Automobile Association, Petitioner, v. United States. | On Writ of Certiorari to the United States Court of Claims.

[June 19, 1961.]

Mr. Justice Clark delivered the opinion of the Court.

In this suit for refund of federal income taxes the petitioner, American Automobile Association, seeks determination of its tax liability for the years 1952 and 1953. Returns filed for its taxable calendar years were prepared on the basis of the same accrual method of accounting as was used in keeping its books. The Association reported as gross income only that portion of the total prepaid annual membership dues, actually received or collected in the calendar year, which ratably corresponded with the number of membership months, covered by those dues, occurring within the same taxable calendar year. The balance was reserved for ratable monthly accrual over the remaining membership period in the following calendar year as deferred or unearned income reflecting an estimated future service expense to members. The Commissioner contends that petitioner should have reported in its gross income for each year the entire amount of membership dues actually received in the taxable calendar year without regard to expected future service expense in the subsequent year. The sole point at issue, therefore, is in what year the prepaid dues are taxable as income.

In auditing the Association's returns for the years 1952 through 1954, the Commissioner, in exercise of his discre-

tion under § 41 of the Internal Revenue Code of 1939,[1] determined not to accept the taxpayer's accounting system. As a result, adjustments were made for those years principally by adding to gross income for each taxable year the amount of prepaid dues which the Association had received but not recognized as income, and subtracting from gross income amounts recognized in the year although actually received in the prior year. A net operating loss claimed for 1954 and corresponding carryback deductions were greatly reduced, and tax deficiencies were assessed for 1952 and 1953. Petitioner paid the deficiencies and its timely claim for refund was denied. Suit to recover was instituted in the Court of Claims, but the court sustained the Commissioner, 181 F. Supp. 255. Recognizing a conflict between the decision below and that in *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, we granted certiorari. 364 U. S. 813. We have concluded that for tax purposes the dues must be included as income in the calendar year of their actual receipt.

The Association is a national automobile club organized as a nonstock membership corporation with its principal office in Washington, D. C. It provides a variety of services[2] to the members of affiliated local automobile clubs and those of ten clubs which taxpayer itself directly

[1] A taxpayer's "net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ." 53 Stat. 24, 26 U. S. C. (1952 ed.) § 41. See also the similar provision in the Internal Revenue Code of 1954, 26 U. S. C. (1958 ed.) § 446.

[2] These generally include road maps, routing, tour books, etc.; emergency road service through contracts with local garages; bail bond protection; personal automobile accident insurance and theft protection; and, in some of its divisions, motor license procurement, brake and headlight adjustment service, notarial duties and advice in the prosecution of small claims.

operates as divisions, but such services are rendered solely upon a member's demand. Its income is derived primarily from dues paid one year in advance by members of the clubs. Memberships may commence or be renewed in any month of the year. For many years, the association has employed an accrual method of accounting and the calendar year as its taxable year. It is admitted that for its purposes the method used is in accord with generally accepted commercial accounting principles. The membership dues, as received, were deposited in the Association's bank accounts without restriction as to their use for any of its corporate purposes. However, for the Association's own accounting purposes the dues were treated in its books as income received ratably[3] over the 12-month membership period. The portions thereof ratably attributable to membership months occurring beyond the year of receipt, *i. e.*, in a second calendar year, were reflected in the Association's books at the close of the first year as unearned or deferred income. Certain operating expenses were chargeable as prepaid membership cost and deducted ratably over the same periods of time as those over which dues were recognized as income.

The Court of Claims bottomed its opinion on *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 (1957), finding that "the method of treatment of prepaid automobile club membership dues employed [by the Association here was] . . . for Federal income tax pur-

[3] In 1952 and 1953 dues collected in any month were accounted as income to the extent of one-twenty-fourth for that month (on the assumption that the mean date of receipt was the middle of the month), one-twelfth for each of the next eleven months, and again one-twenty-fourth in the anniversary month. In 1954, however, guided by its own statistical average experience, the Association changed its system so as to more simply reach almost the same result by charging to year of receipt, without regard to month of receipt, one-half of the entire dues payment and deferring the balance to the following year.

poses, 'purely artificial.'" 181 F. Supp. 255, 258. It accepted that case as "a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar." *Ibid.* The Association does not deny that its accounting system is substantially identical to that used by the petitioner in *Michigan*. It maintains, however, that *Michigan* does not control this case because of a difference in proof, *i. e.*, that in this case the record contains expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed, and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience. The holding of *Michigan*, however, that the system of accounting was "purely artificial" was based upon the finding that "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 353 U. S. 180, 189, note 20. That is also true here.[4] As the Association's own accounting expert testified:

> "You are dealing with a group or pool. Any pooling or risk situation, particular members may in a particular year require very little of a specific service that is rendered to certain other members. I wouldn't know what the experience on that would be, but I would think it would be rather irregular between individual members . . . I am buying the availability of services, the protection . . . . Frankly,

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[4] *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, and *Schuessler* v. *Commissioner*, 230 F. 2d 722, may be distinguished from the present case on the same grounds which made them distinguishable in *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180, 189, note 20.

> the irregularity of the actual furnishing of the maps and helping you out when you run out of gasoline and so on. I frankly don't think that has a blessed thing to do with the overall accounting."

It may be true that to the accountant the actual incidence of cost in serving an individual member in exchange for his individual dues is inconsequential, or, from the viewpoint of commercial accounting, unessential to determination and disclosure of the overall financial condition of the Association. That "irregularity," however, is highly relevant to the clarity of an accounting system which defers receipt, as earned income, of dues to a taxable period in which no, some, or all the services paid for by those dues may or may not be rendered. The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.

The Association further contends that the findings of the court below support its position. We think not. The Court of Claims' only finding as to the accounting system itself is as follows:

> "22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field."

This is only to say that in performing the function of business accounting the method employed by the Association "is in accord with generally accepted commercial accounting principles and practices." It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury.[5] Likewise, other findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinant significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit. Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the *pro rata* method of allocating each year's membership dues in equal monthly installments not in fact related to the expenses incurred. Not only did individually incurred expenses actually vary from month to month, but even the average expense varied—recognition of income nonetheless remaining ratably constant. Although the findings below seem to indicate that it would produce substantially the same result as that of the system of ratable monthly recognition actually employed, we consider similarly unsatisfactory, from an income tax standpoint, allocation of monthly dues to gross monthly income to the extent of actual service expenditures for the same month computed on a group or pool basis. In addition, the Association's election in 1954 to change its monthly recognition formula [6] to one which treats one-half of the dues as income in the year of receipt and the other half as income received in the subsequent

[5] The Hearing Commissioner of the Court of Claims had specifically found as fact that petitioner's "method of accounting . . . clearly reflected its net income for such years." The court, however, did not adopt that finding.

[6] See note 2, *supra*.

year, without regard to month of payment, only more clearly indicates the artificiality of its method, at least so far as controlling tax purposes are concerned. Moreover, the Association realized that the findings of the Court of Claims were not alone sufficient for its purposes. In its petition for rehearing below, petitioner specifically asked that they be amended and enlarged, especially as to No. 22 set out above. Rehearing and amendment were denied.

Whether or not the Court's judgment in *Michigan* controls our disposition of this case, there are other considerations requiring our affirmance. They concern the action of the Congress with respect to its own positive and express statutory authorization of employment of such sound commercial accounting practices in reporting taxable income. In 1954 the Congress found dissatisfaction in the fact that "as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income." House Ways and Means Committee Report, H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48. As a result, it introduced into the Internal Revenue Code of 1954 § 452 and § 462[7] which specifically permitted essentially the same practice as was employed by the Association here.[8] Only one year later, however,

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[7] 26 U. S. C. (1952 ed., Supp. II) §§ 452, 462, repealed, 69 Stat. 134 (1955).

[8] The Senate Report included this language:

"Under the 1939 Code, regardless of the method of accounting . . . amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use

in June 1955, the Congress repealed these sections retroactively. It appears that in this action Congress first overruled the long administrative practice of the Commissioner and holding of the courts in disallowing such deferral of income for tax purposes and then within a year reversed its own action. This repeal, we believe, confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not "intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes. . . ." H. R. Rep. No. 293, 84th Cong., 1st Sess. 4, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends. To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted § 452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound." Instead of constituting a merely duplicative creation, the fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy. We are further confirmed in this view by consideration of the even

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by the taxpayer even though the payments are for goods or services to be provided by the taxpayer at a future time." S. Rep. No. 1622, 83d Cong., 2d Sess. 301.

more recent action of the Congress in 1958, subsequent to the decision in *Michigan, supra.* In that year § 455 [9] was added to the Internal Revenue Code of 1954. It permits publishers to defer receipt as income of prepaid subscriptions of newspapers, magazines and periodicals. An effort was made in the Senate to add a provision in § 455 which would extend its coverage to prepaid automobile club membership dues.[10] However, in conference the House Conferees refused to accept this amendment. Senator Byrd explained the rejection of the amendment to the Senate (104 Cong. Rec., Part 14, p. 17744):

> "It was the position of the House conferees that this matter of prepaid dues and fees received by nonprofit service organizations was a part of the entire subject dealing with the treatment of prepaid income and that such subject should be left for study of this entire problem. . . ." [11]

It appears, therefore, that, pending its own further study, Congress has given publishers but denied automobile clubs the very relief that the Association seeks in this Court.

To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it en-

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[9] 28 U. S. C. (1958 ed.) § 455.

[10] An unsuccessful attempt to induce congressional action on this problem was made last year, see H. R. 11266, 86th Cong., 2d Sess., which passed in the House in August, 1960, 106 Cong. Rec. (Daily ed.) 16256 but failed to draw any action by the Senate before adjournment. An identical bill is currently pending, see H. R. 929, 87th Cong., 1st Sess., and H. R. Rep. No. 381 accompanying the bill and recommending its passage. Under that measure the taxpayer's liability to its members "*shall be deemed to exist ratably* over the period that such services are required to be rendered, or . . . privileges . . . made available."

[11] The Eighty-fourth Congress started the study of "legislation dealing with prepaid income and reserves for estimated expenses . . . ." S. Rep. No. 372, 84th Cong., 1st Sess. 6.

acted § 452 and § 462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan*, is ratably earned by performance on "publication dates after the tax year." 353 U. S. 180, 189, note 20. It has refused to enlarge § 455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case.[12] Finding only that, in light of existing provisions not specifically authorizing it, the exercise of the Commissioner's descretion in rejecting the Association's accounting system was not unsound, we need not anticipate what will be the product of further "study of this entire problem."

Affirmed.

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[12] In 1955 it was estimated that transitional loss of revenue under § 452 and § 462, repealed that year, would total in excess of a billion dollars. H. R. Rep. No. 293, 84th Cong., 1st Sess. 3. That this impact on the revenue continues to be an important factor in congressional consideration of the problem is indicated by the observation of the House Committee on Ways and Means that a "transitional rule" is necessary "to minimize the initial revenue impact" of the measure currently pending. H. R. Rep. No. 381, 87th Cong., 1st Sess. 4. That the system used by petitioner here is, perhaps, presently not uncommon may be indicated by the fact that during this Term alone several cases involving similar systems have reached this Court.

SUPREME COURT OF THE UNITED STATES

No. 288.—October Term, 1960.

American Automobile Association, Petitioner, v. United States. } On Writ of Certiorari to the United States Court of Claims.

[June 19, 1961.]

Mr. Justice Stewart, whom Mr. Justice Douglas, Mr. Justice Harlan and Mr. Justice Whittaker join, dissenting.

In *Automobile Club of Michigan* the Court pointed out that the method of accounting employed by the taxpayer was "purely artificial," so far as the record there showed. 353 U. S., at 189. Here, by contrast, the petitioner proved, and the Court of Claims found, that the method of accounting employed by the petitioner during the years in issue was in accord with generally accepted commercial accounting principles and practice, was customarily employed by similar taxpayers, and, in the opinion of qualified experts in the accounting field, clearly reflected the petitioner's net income. I do not understand that the Court today questions either that proof or those findings.[1]

[1] The Court does not, for example, challenge Finding No. 26 of the Court of Claims:

"Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed."

The Court thus holds that the Commissioner is authorized to disregard and override a method of reporting income under which prepaid dues are deferred in direct relation to the taxpayer's costs under its membership contracts. The effect of the Court's decision is to allow the Commissioner to prevent an accrual basis taxpayer from making returns in accordance with the accepted and clearly valid accounting practice of excluding from gross income amounts received as advances until the right to such amounts is earned by rendition of the services for which the advances were made. To permit the Commissioner to do this, I think, is to ignore the clear statutory command that a taxpayer must be allowed to make his returns in accord with his regularly employed method of accounting, so long as that method clearly reflects his income.[2] The result, I am afraid, will be to engender far-reaching confusion and injustice in the administration of the Internal Revenue Laws.[3]

I.

The Commissioner's basic argument against the deferred reporting of prepayments has traditionally been that such

[2] Int. Rev. Code of 1939, § 41, 53 Stat. 24; Int. Rev. Code of 1954, § 446, 26 U. S. C. § 446.

[3] The scope of the problem is well illustrated by the reported cases. See, *e. g.*, *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (rent received in advance); *Clay Sewer Pipe Assn.* v. *Commissioner*, 139 F. 2d 130 (subscriptions for promotion campaign to be consummated in years subsequent to receipt); *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (advance newspaper subscription payments); *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520 (advance payments in a television servicing contract); *Scalude* v. *Commissioner*, 283 F. 2d 234 (fees for dancing lessons paid in advance); *Wallace A. Moritz*, 21 T. C. 622 ("customers' deposits" on undeveloped photographs); *South Tacoma Motor Co.*, 3 T. C. 411 (proceeds from sale of coupons entitling bearer to garage services in later years); *Your Health Club, Inc.*, 4 T. C. 385 (advance payments for use of gym and other facilities); *Northern Illinois College of Optometry*, 2 CCH Tax Ct. Mem. 664 (tuition paid in advance).

a method conflicts with a series of decisions of this Court which establish the so-called "claim of right doctrine." [4] In this case the Government abandoned that argument, with good reason. As four Circuits have correctly held, the claim of right doctrine furnishes no support for the Government's position. *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 524, 525–528 (C. A. 2d Cir.); *Schlude* v. *Commissioner*, 283 F. 2d 234 (C. A. 8th Cir.); *Schuessler* v. *Commissioner*, 230 F. 2d 722, 725 (C. A. 5th Cir.); *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, 699–701 (C. A. 10th Cir.).[5] A claim of right without "restriction on use" may be the crucial factor in determining that particular funds are includable in gross income. See *North American Oil* v. *Burnet*, 286 U. S. 417; *United States* v. *Lewis*, 340 U. S. 590; *Healy* v. *Commissioner*, 345 U. S. 278. But it hardly follows that all such funds must necessarily be reported by an accrual basis taxpayer as income in the year of receipt, whether or not then earned.

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[4] Almost all of the decisions sustaining the Commissioner's disallowance of deferred reporting of advances by accrual basis taxpayers have relied on the claim of right doctrine. See, *e. g.*, *Curtis R. Andrews*, 23 T. C. 1026, 1032–1033 (Tax Court); *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C. A. 5th Cir.) (but compare *Schuessler* v. *Commissioner*, 230 F. 2d 722; *Clay Sewer Pipe Assn.* v. *Commissioner*, 139 F. 2d 130 (C. A. 3d Cir.); *Automobile Club of Michigan* v. *Commissioner*, 230 F. 2d 585, 591 (C. A. 6th Cir.), aff'd on other grounds, 353 U. S. 180. The Tax Court has carried the claim of right doctrine to the point where it was found applicable to advance fees which were due but not yet paid. *Your Health Club, Inc.*, 4 T. C. 385.

[5] The rejection of the applicability of the claim of right doctrine in these cases has been enthusiastically approved by legal commentators. See, *e. g.*, Gelfand, The "Claim of Right" Doctrine, 33 Taxes 726; Wolder, Deduction of Reserves for Future Expenses and Deferring of Prepaid Income, 34 Taxes 524; Note, 59 Col. L. Rev. 942, 946. But cf. Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev., 727, 730–732, 747.

The Government shifted its argument in this case to the contention that the "annual accounting requirement" demands that "[n]either income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions." The Government finds a basis for this argument in such cases as *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; *Brown* v. *Helvering*, 291 U. S. 193; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493; and *Hener* v. *Mellon*, 304 U. S. 271.

The Court today does not base its decision on this theory, presumably because the Court believes, as I do, that the theory is not valid. Putting to one side the point that many of the cases relied on involved cash basis taxpayers,[6] these decisions no more pertain to deferred reporting of totally unearned receipts than do the claim of right decisions. These cases, like the claim of right cases, start from the premise that the income in question

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[6] See, *e. g.*, *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. In the latter case, the Court took special notice of the fact that the taxpayer had not "attempted to avail itself" of the accrual sytem under which "expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another." 282 U. S., at 366. In *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, the taxpayer was attempting to use what the Court described as "a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system." 321 U. S., at 287. In *Brown* v. *Helvering*, 291 U. S. 193, the taxpayer was on accrual basis generally, but its assertion of a right to defer reporting "overriding commissions" constituted a change in accounting procedures as to the acceptance of which the Commissioner was said to have "wide discretion." 291 U. S., at 204. See the discussion in *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 525–526.

has been fully earned.[7] The underlying premise of the annual accounting requirement is that *otherwise reportable income* derived from a transaction cannot be excluded from gross income in order to let the taxpayer wait to see in a later year how the overall transaction turns out.[8] That is not the issue in this case. The question here is whether any reportable income has been derived from a transaction when payments are received in advance of performance.

Although wisely rejecting the claim of right and annual accounting arguments, the Court decides this case upon grounds which seem to me equally invalid. I can find nothing in *Automobile Club of Michigan* which controls disposition of this case. And the legislative history upon which the Court alternatively relies seems to me upon examination to be singularly unconvincing.

In *Michigan* there was no offer of proof to show the rate at which the taxpayer fulfilled its obligations under its membership contracts. The deferred reporting of prepaid dues was, therefore, rejected in that case simply because there was no showing of a correlation between the amounts

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[7] With the possible exception of contingent related expenditures, which cannot be accurately measured. See *Brown* v. *Helvering*, 291 U. S. 193, 200–201.

[8] This becomes entirely clear upon examination of the cases upon which the Government relies. For example, in *Heiner* v. *Mellon*, 304 U. S. 271, members of partnerships which had been formed to liquidate two corporations attempted to defer reporting income earned during the year until it could be determined in a subsequent year whether the partnerships' overall liquidation enterprise had been profitable. The Court held that such a postponement was barred by the annual accounting principle. In *Security Mills Co.* v. *Commissioner*, 321 U. S. 81, the taxpayer attempted to reopen a prior year's return so as to deduct amounts which it had subsequently paid out of receipts earned in that year. Again the Court relied on the annual accounting principle in denying the taxpayer's claim.

deferred and the costs incurred by the taxpayer in carrying out its obligations to its members. Until today, that case has been recognized as one that simply held that, in the absence of proof that the proration used by the taxpayer reasonably matched actual expenses with the earning of related revenue, the Commissioner was justified in rejecting the taxpayer's proration. I am hardly alone in thinking that *Michigan* was decided upon the very premise that a realistic deferral of income based upon proof of average costs of service during identifiable periods would be entirely permissible. See *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 526–529.[9] Such proof was concededly adduced in this case.

As to the enactment and repeal of § 452 and § 462, upon which the Court places so much reliance, there are, at the outset, obvious difficulties in relying on what happened in 1954 and 1955 to ascertain the meaning of § 41 of the 1939 Code. See *Fogarty* v. *United States*, 340 U. S. 8, 13–14; *Gemsco, Inc.*, v. *Walling*, 324 U. S. 244, 265; *Cammarano* v. *United States*, 358 U. S. 498, 510. But these problems aside, I think that the enactment and subsequent repeal of § 452 and § 462 give no indication of Congressional approval of the position taken by the Commissioner in this case. If anything, the legislative action leads to the contrary impression.

The statutory provisions in question were passed as part of a general revision of the internal revenue laws in 1954. Section 452 permitted an accrual basis taxpayer to defer the inclusion of advances in gross income until they were earned.[10] Most significantly, a taxpayer could shift to

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[9] See also Hoffman, Accounting Treatment Counts in Determining Net Taxable Income, 35 Taxes 918, 921; Behren, Prepaid Income-Accounting Concepts and The Tax Law, 15 Tax L. Rev. 343, 359–360; Note, 67 Yale L. J. 1425, 1439–1440.

[10] There were certain restrictions upon the period over which the advances could be deferred, but these are not relevant for our pur-

this method without the consent of the Cominissioner. Section 462, which permitted the deduction of anticipated expenses, was not aimed specifically at the problem of reporting advances.[11] The function of the provisions was to bring "[t]ax accounting . . . more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." [12]

In seeking to accomplish this objective, Congress recognized that as a result of "court decisions and rulings," the claim of right approach had been used to require reporting for the year of receipt all payments "subject to free and unrestricted use . . . even though the payments are for goods or services to be provided by the taxpayer at a future time." H. R. Rep. No. 1337, 83d Cong., 2d Sess.

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poses here. See Proposed Treas. Reg. §1.452, 20 Fed. Reg. 515; Wolder, Deduction of Reserves for Future Expenses and Deferring of Prepaid Income, 34 Taxes 524; Bierman and Helstein, Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954, 10 Tax L. Rev. 83, 93–96. Section 452 specifically envisaged the deferral of club dues. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48.

[11] See, *e. g.*, S. Rep. No. 372, 84th Cong., 1st Sess. 2. Section 462 provided that, "In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses . . . ." § 462 (a), 68A Stat. 158. "Estimated expense" was defined as a deduction "(A) part or all of which would . . . be required to be taken into account for a subsequent taxable year; (B) which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and (C) which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy." § 462 (d) (1), 68A Stat. 158. See Bierman and Helstein, Accounting For Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954, 10 Tax L. Rev. 83, 103–113.

[12] S. Rep. No. 372, 84th Cong., 1st Sess. 3 (quoting from the tax recommendation in the Presidential budget message of 1954).

48, A159.[13] Congressional awareness of administrative and judicial misapplication of the claim of right doctrine clearly did not imply approval of it. For by 1954, "[i]t was long recognized that the difficulty lay, not with the statute, but with administrative and court interpretation." [14] And while the Committee reports contain no express rejection of the Commissioner's interpretation of the 1939 statute, the language used in explaining the need for a change certainly indicates disapproval.[15]

Although § 452 and § 462 were short-lived, the shape of the decisional law with respect to § 41 of the 1939 Code changed considerably during the interval between the passage and repeal of the new sections. In *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, the Tenth Circuit rejected the Commissioner's reliance on the claim of right rationale and found that the deferment of

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[13] There were some exceptions to the rigid application of this rule which had been recognized. See I. T. 3369, 1940–1 Cum. Bull. 46 (permitting deferred reporting of subscriptions for publishers who had consistently followed that practice); I. T. 2080, III–2 Cum. Bull. 48 (permitting deferment of receipts from sales of tickets for tourist cruises), but compare *National Airlines, Inc.*, 9 T. C. 159. See also *Veenstra & DeHaan Coal Co.*, 11 T. C. 964; *Summit Coal Co.*, 18 B. T. A. 983.

[14] Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev. 727, 729, n. 9. See Bierman and Helstein, Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954, 10 Tax L. Rev. 83, 84.

[15] "Present law provides that the net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed by the taxpayer, if such method clearly reflects the income and the regulations state that approved standard methods of accounting will ordinarily be regarded as clearly reflecting taxable income. Nevertheless, as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles . . . ." H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48.

advances in accord with accrual principles did "clearly reflect . . . income" under § 41. At about the same time a Ninth Circuit decision permitted income received from the sale of goods to be offset by a deduction for the future expense of shipping the goods. *Pacific Grape Products Co.* v. *Commissioner*, 219 F. 2d 862.

When Congress repealed § 452 and § 462, the record shows that it was fully aware of these decisions. Congress recognized that the rationale of these cases would produce a complete reversal of the previous administrative position with respect to the reporting of unearned receipts under § 41 and its counterpart under the 1954 Code, § 446. Congressional intent with respect to this possibility was entirely clear—the trend of judicial decisions should be allowed to run its course *without any inference of disapproval being drawn from the repeal of § 452 and § 462.* This intent was evidenced in the assurances which the House Ways and Means Committee demanded and received from the Secretary of the Treasury, who had sought the repeal of the two sections. In a letter to the Chairman of the Committee, the Secretary stated:

> "My dear Mr. Chairman: This letter will confirm the statements made to you today by Treasury representatives.
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> . . . . . .
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> "Furthermore, the Treasury Department will not consider the repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions *and other items of prepaid income, either under prior law or under other provisions of the 1954 code.* In other words, the repeal of section 452 will not be considered by the Department as either the acceptance or the rejection by Congress of the decision in *Beacon Publishing Co. v. Commis-*

sioner (218 F. (2d) 697, C. A. 10, 1955) or any other judicial decisions.

"It is my understanding *that the foregoing is consistent with the desire of your committee, with which I agree,* that the repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted." H. R. Rep. No. 293, 84th Cong., 1st Sess. 5. (Emphasis supplied.)

The same viewpoint was expressed in the Senate Report, which stated:

"Another aspect of the uncertainty with respect to subscription income if section 452 is repealed arises from a recent circuit court decision in *Beacon Publishing Company* v. *Commissioner* (C. C. A. 10th, January 3, 1955). The court in this case held that the deferral of prepaid subscription income was in fact proper under the accrual method of accounting. The Secretary of the Treasury in the letter previously referred to which he sent to the chairman of the House Committee on Ways and Means indicated that the repeal of section 452 would not be taken as an indication by the Treasury Department of congressional intent as to the proper treatment of prepaid subscription income under prior law or under other provisions of the 1954 code. He also indicated that the repeal of section 452 will not be considered by the Department as either acceptance or rejection by Congress of the decision in *Beacon Publishing Company* v. *Commissioner* or in any other judicial decisions. . . .

. . . . . .

"Uncertainty will also exist in other areas with the repeal of these two provisions. In *Pacific Grape Products* (C. C. A. 9th, February 10, 1955), for exam-

ple, the circuit court held that certain freight and shipping expenses incurred after the end of the year could be accrued for tax purposes as of the end of the year. An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed." S. Rep. No. 372, 84th Cong., 1st Sess. 5–6.[16]

To my mind, this legislative history shows that Congress made every effort to dissuade the courts from doing exactly what the Court is doing in this case—drawing from the repeal of § 452 an inference of Congressional disapproval of deferred reporting of advances.[17] But even if the legislative history on this point were hazy, the same conclusion would have to be reached upon examination of Congressional purpose in repealing § 452 and § 462. Cf. *United States* v. *Benedict*, 338 U. S. 692, 696. For the fact of the matter is, contrary to the impression left by the Court's opinion, that the reasons for rejecting § 452 and § 462 were entirely consistent with accepting the deferred reporting of receipts in a case like this. Sections 452 and 462 were repealed *solely* because of a prospective loss of revenue during the first year in which taxpayers would take advantage of the new sections.[18]

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[16] See also H. R. Rep. No. 293, 84th Cong., 1st Sess. 4–5.

[17] It is to be noted that no such inference was relied upon in the *Michigan* case, although the same arguments with respect to §§ 452 and 462 were pressed upon the Court by the Government. See Brief for Respondent, pp. 62–65, *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180.

[18] See H. R. Rep. No. 293, 84th Cong., 1st Sess. 2–5; S. Rep. No. 372, 84th Cong., 1st Sess. 4–5; Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess. 6. The prospective loss was more than ten times the original estimate of 47 million. *Ibid.* See Note, 67 Yale L. J. 1425, 1432, n. 25.

Insofar as the reporting of advances was concerned, that loss of revenue would have occurred solely as a consequence of taxpayers changing their method of reporting, without the necessity of securing the Commissioner's consent, to that authorized under § 452 and § 462.[19] The taxpayer who shifted his basis for reporting advances would have been allowed what was commonly termed a "double deduction" during the transitional year.[20] Under § 462, deductions could be taken in the year of change for expenses attributable to advances taxed in prior years under a claim of right theory, as well as for reserves for future expenditures attributable to advances received and reported during that year. Similarly, under § 452, prepayments received during the year of transition would be excluded from gross income while current expenditures attributable to past income would still be deductible.[21]

The Congressional purpose in repealing § 452 and § 462—maintenance of the revenues—does not, however, require disapproval of sound accounting principles in cases of taxpayers who, like the petitioner, have custo-

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[19] There was also a problem of expanded use of reserves for estimated expenditures under § 462 for items like vacation pay which were not related to the reporting of advances. See Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess. 5, 9; Sporrer, The Past and Future of Deferring Income and Reserving for Expenses, 34 Taxes 45, 55–56; Griswold, Federal Taxation (5th ed. 1960), 497–498.

[20] See S. Rep. No. 372, 84th Cong., 1st Sess. 4; Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess., at 7, 8, 10; Dakin, The Change from Cash to Accrual Accounting for Federal Income Tax Purposes—Pyramided Income, Double Deductions and Double Talk, 51 Nw. U. L. Rev. 515, 530–538; Griswold Federal Taxation (5th ed. 1960), 497–498; Note, 67 Yale L. J. 1424, 1430.

[21] Only one-tenth of the estimated loss during the transitional year was attributable to § 452. See Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess. 21.

marily and regularly used a sound accrual accounting method in reporting advance payments. No transition is involved, and no "double deduction" is possible. Moreover, taxpayers formerly reporting advances as income in the year of receipt can now shift to a true accrual system of reporting only with the approval of the Commissioner. See Treas. Reg. 111, § 29.41–2 (1942); Treas. Reg. 118, § 39.41–2 (c) (1953); Int. Rev. Code of 1954, § 446 (e).[22] Before giving his approval the Commissioner can be expected to insist upon adjustments in the taxpayer's transition year to forestall any revenue loss which would otherwise result from the change in accounting method. See *Kahuku Plantation Co.* v. *Commissioner*, 132 F. 2d 671, 674; 2 Mertens, Law of Federal Income Taxation, §§ 12.21, 12.21a. Cf. *Brown* v. *Helvering*, 291 U. S. 193, 204.

In short, even if the legislative history of the repeal of § 452 and §462 did not clearly indicate, as it does, that the repeal of those sections should have no bearing upon judicial determination of whether the deferred reporting of advances "clearly reflects income," the purpose of the Congress which repealed those provisions would lead to the same conclusion. It need hardly be added that the subsequent legislative activity cited by the Court in no way alters this conclusion. Contrary to the Court's suggestion, the "relief that the Association seeks in this Court" is far short of what was sought in 1958 in urging that the coverage of § 455 be extended to prepaid automobile club membership dues. As enacted, § 455 was not limited in application to publishers previously reporting prepaid subscriptions on a deferral basis. See I. T. 3369, 1940–1 Cum. Bull. 46. It applied to all publishers using the accrual method and permitted a change

[22] See also Treas. Reg. § 1.446–1 (e) (2) (1957); *Brown* v. *Helvering*, 291 U. S. 193, 204–205; *Advertisers Exchange, Inc.*, 25 T. C. 1086, 2 Mertens, Law of Federal Income Taxation, § 12.19–12.20.

to deferred reporting of subscriptions for the year 1958 *without consent* of the Commissioner. 26 U. S. C. § 455 (c)(3)(B).

II.

I think the Government's position in this case is at odds with the statutes,[23] regulations,[24] and court decisions,[25] which, since 1916, have recognized that realistic accrual

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[23] The Revenue Act of 1913, 38 Stat. 114, provided only for a strict cash receipts and disbursements method of accounting. See *e. g.*, § 2 (b), 38 Stat. 167. In the 1916 Act, the sections dealing with permissible methods of computing income were revised to provide that:

"A corporation . . . keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, . . ." § 13 (d), 39 Stat. 771. See also § 8 (g), 39 Stat. 763 (identical provision with respect to returns filed by individuals).

These sections were designed specifically to permit accrual accounting. See H. R. Rep. No. 922, 64th Cong., 1st Sess. 4; *United States* v. *Anderson*, 269 U. S. 422, 439–441. In the Revenue Act of 1918, the necessity of obtaining special permission to use the accrual method was omitted, see § 212 (b), 40 Stat. 1064–1065, and the provision permitting the use of accrual accounting remained substantially the same for the next thirty-six years. See Int. Rev. Code of 1939, § 41, 53 Stat. 24; Henry Reubel, 1 B. T. A. 676, 677–678. In 1954 the pertinent provision was again changed, with specific mention of the "accrual method." See Int. Rev. Code of 1954, § 446, 26 U. S. C. § 446. See generally, May, Accounting and the Accountant in the Administration of Income Taxation, 47 Col. L. Rev. 377, 380–382.

[24] See, *e. g.*, T. D. 2433, 19 Treas. Dec. 5 (1917); Treas. Reg. 45, § 212, Art. 23; § 214, Art. 111 (1920); Treas. Reg. 118, § 39.41 (1953); Treas. Reg. § 1.446–1 (1957).

[25] See, *e. g.*, *United States* v. *Anderson*, 269 U. S. 422; *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 184–185; see also *Weed & Brothers* v. *Commissioner*, 38 F. 2d 935, 938–940.

accounting does "clearly reflect income." If I am correct, the law did not give the Commissioner any "discretion . . . not to accept the taxpayer's accounting system."

The basic concept of including advances in gross income only as they are earned is but an aspect of accrual accounting principles which have consistently received judicial approval. We have, for example, often recognized that deductions for business expenses must be reported as soon as the obligation to pay becomes "certain." See, *e. g.*, *United States* v. *Anderson*, 269 U. S. 422; *American National Co.* v. *United States*, 274 U. S. 99; *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 360; *United States* v. *Olympic Radio and Television*, 349 U. S. 232, 236. This may be before or after cash payment is made,[26] or even before it is due.[27] The controlling factor is not the flow of cash, but the "economic and bookkeeping" principles with which § 41 is concerned. *United States* v. *Anderson*, *supra*, at 441. See also *American National Co.* v. *United States*, *supra*. These principles are at the foundation of the so-called "all events" test for determining the accrual of deductions. See *United States* v. *Anderson*, *supra*, at 441; [28] *United States* v. *Consoli-*

[26] Compare, *e. g.*, *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 94 (deduction taken in year prior to cash disbursement) with *Shelby Salesbook Co.* v. *United States*, 104 F. Supp. 237 (deduction taken in later year).

[27] *United States* v. *Anderson*, 269 U. S. 422; *American National Co.* v. *United States*, 274 U. S. 99; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92.

[28] The Court there held that an accrual taxpayer should have deducted a tax expense in 1916 so that it properly could have been offset against the profits from sales in 1916 upon which the tax was levied. The Court rejected the contention that the tax could not accrue in 1916 because it was not due until 1917. It stated:

"In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of

dated Edison Co., — U. S. —, —. The same principles are applicable to the accrual of income. See *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290. As has been correctly noted, "[i]t is a necessary corollary of this 'economic and bookkeeping' proposition" upon which *Anderson* rested that receipts are not reportable in income until "substantially 'all the events' have occurred, both as to the cost and time of performance, which must occur in order to discharge the liability to perform which was given by [the taxpayer] in return for the receipt." *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 524. See also *United States* v. *Anderson*, *supra*, at 440; *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, 699. Indeed, "accrual" of income has been commonly defined in terms of "earnings" from the sale of goods or the performance of services. See, *e. g.*, *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 184–185; Stanley and Kilcullen, The Federal Income Tax (3d ed. 1955), 190.[29] In reject-

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the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued. It should be noted that § 13 (d) makes no use of the words 'accrue' or 'accrual' but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income—which is precisely the return insisted upon by the Government." 269 U. S., at 441.

[29] The authors there state:

"In the ordinary case, accrual precedes actual receipt since there is an accrual when there is a *right* to receive. But in some cases items are received before they are earned, and then the receipt precedes the accrual."

See also *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290; *Georgia School-Book Depository, Inc.*, 1 T. C. 463; 1961 C. C. H. Tax Reporter § 2820.025 ("On the accrual basis, income is reported when earned"); Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev. 727, 728.

ing petitioner's method of allocating prepaid advances, the Court, I think, disregards these basic principles.

The net effect of compelling the petitioner to include all dues in gross income in the year received is to force the petitioner to utilize a hybrid accounting method—a cash basis for dues and an accrual basis for all other items. *Schlude* v. *Commissioner*, 283 F. 2d 234, 239. Cf. *Commissioner* v. *South Texas Co.*, 333 U. S. 496, 501. For taxpayers generally the enforcement of such a hybrid accounting method may result in a gross distortion of actual income, particularly in the first and last years of doing business. On the return for the first year in which advances are received, a taxpayer will have to report an unrealistically high net income, since he will have to include unearned receipts, without any offsetting deductions for the future cost of earning those receipts. On subsequent tax returns, each year's unearned prepayments will be partially offset by the deduction of current expenses attributable to prepayments taxed in prior years. Even then, however, if the taxpayer is forbidden to correlate earnings with related expenditures, the result will be a distortion of normal fluctuations in the taxpayer's net income. For example, in a year when there are low current expenditures because of fewer advances received in the preceding year, the result may be an inflated adjusted gross income for the current year. Finally, should the taxpayer decide to go out of business upon fulfillment of the contractual obligations already undertaken, in the final year there will be no advances to report and many costs attributable to advances received in prior years. The result will be a grossly unrealistic reportable net loss.

The Court suggests that the application of sound accrual principles cannot be accepted here because deferment is based on an estimated rate of earnings, and because this estimate, in turn, is based on average, not

individual, costs. It is true, of course, that the petitioner cannot know what service an individual member will require or when he will demand it. Accordingly, in determining the portion of its outstanding contractual obligations which have been discharged during a particular period (and hence the portion of receipts earned during that period), the petitioner can only compare the total expenditures for that period against estimated average expenditures for the same number of members over a full contract term. But this use of estimates and averages is in no way inconsistent with long-accepted accounting practices in reflecting and reporting income.

As the Government has pointed out in past litigation, "many business concerns . . . keep accounts on an accrual basis and have to estimate for the tax year the amount to be received on transactions undoubtedly allocable to such year." *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290, 295–296. Similarly, the deduction of future expenditures which have already accrued often requires estimates like those involved here. See, *e. g.*, *Harrold v. Commissioner*, 192 F. 2d 1002; *Schuessler* v. *Commissioner*, 230 F. 2d 722; *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930, 934–937; *Hilinski* v. *Commissioner*, 237 F. 2d 703. Finally, it is to be noted that the regulations under both the 1939 and 1954 Codes permit various methods of reporting income which require the use of estimates.[30] In the absence of any showing that the

[30] See, *e. g.*, Treas. Reg. 111, § 29.42-4 (1942), Treas. Reg. 118, § 39.42-4 (1953), and Treas. Reg. § 1.451-3 (1957) (providing for the percentage of completion method of reporting income on long-term contracts); Treas. Reg. 111, § 29.42-5 (1942), Treas. Reg. 118, § 39.42-5 (1953), and Treas. Reg. § 1.451-4 (1957) (providing for the deduction for redemption of trading stamps based upon "the rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year"). See generally *Brown & Williamson Tobacco Corp.*, 16 T. C. 432.

estimates used here were faulty, I think the law did not permit the Commissioner to forbid the use of standard accrual methods simply upon the ground that estimates were necessary to determine what the rate of deferral should be.

Similarly, it is not relevant that the petitioner "defers receipt . . . of dues to a taxable period in which, no, some, or all the services paid for by those dues may or may not be rendered." The fact of the matter is that what the petitioner has an obligation to provide, *i. e.*, the constant readiness of services if needed, will with certainty be provided during the period to which deferment has been made. Averages are frequently utilized in tax reporting. In computing the value of work in process, in distributing overhead to product cost, and in various other areas, the use of averages has long been accepted. See, *e. g.*, *Rookwood Pottery Co.* v. *Commissioner*, 45 F. 2d 43; *Eatonville Lumber Co.*, 10 B. T. A. 232. The use of an "average cost" is particularly appropriate here where the dues are earned by making services continuously available. The cost of doing so must necessarily be based on composite figures.

For these reasons I think that the petitioner's original returns clearly reflected its income, that the Commissioner was therefore without authority under the law to override the petitioner's accounting method, and that the judgment should be reversed.